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OBJECTIONS TO A COMPENSATED DOLLAR

There is little room for difference of opinion as to the importance of preventing fluctuations in the general level of prices. If this level is falling, numerous interests and industries suffer special injury; if prices rise, others bear the chief burden; while all classes in the community are more or less harmed by a movement in either direction.

Any proposal that offers relief deserves consideration, but because of the importance of the interests affected, only a most searching criticism of it will be adequate. The underlying theoretical assumptions should be examined to determine their soundness; the practical obstacles to the adoption of the plan should be considered; and, finally, as many as possible of the details of its operation should be analyzed. Many a device that in its general features seemed theoretically sound and politically feasible, has met disaster because certain apparently unimportant difficulties in operation have been overlooked.

Professor Fisher's plan for a compensated dollar is being subjected to these various forms of analysis. From the theoretical side it has been pointed out that its use of the multiple or tabular standard opens it to all of the objections that may be urged against such a method of correcting price fluctuations.¹ Although Professor Fisher does not admit it, the plan also seems to most critics to be based on the quantity theory of money, as to the accuracy of which there is by no means a general agreement. Even those who accept this theory as an explanation of price movements are not in accord as to the closeness of the connection between the quantity of money and prices and the promptness with which prices will respond to a change in the supply of coined gold.

From the standpoint of political expediency Professor Taussig has recently shown² that an international adoption of the plan would probably be impossible and that a single country would not be likely to attempt it alone. Still other reasons for this conclusion might perhaps be urged, but this paper will be confined to the third of the lines of criticism mentioned above—certain difficulties that would probably be encountered in the operation of the plan. Assuming that it is theoretically sound and that the legislation

¹ For one of the most recent of these criticisms see an article by Professor Kinley in *AMERICAN ECONOMIC REVIEW*, March, 1913.

² *Quarterly Journal of Economics*, May, 1913.

necessary for its adoption could be enacted, is it a workable device?

Professor Fisher has acknowledged the existence of certain obstacles, but there is danger that these very admissions will serve to turn the discussion into other channels. They deserve analysis, however, because they may be of enough significance to prevent the success of a plan otherwise satisfactory.

First, and perhaps most important, would be its serious effect on many long-term contracts. Professor Fisher has admitted that the device could not be applied to check a fall in prices—that “the ‘seigniorage’ must never, of course, be negative.”³ If the “mint-bullion” were less than the amount of bullion in the coin dollar there would be an opportunity for enormous gain by the simple process of melting the coins and exchanging the bullion thus secured for a larger amount in the coined form. These coins would in turn be melted for sale to the mint, there being made on each transaction a profit whose amount would be determined by the difference between the weight of the dollar and the mint-bullion. This process could be kept up with indefinitely great profit to the dealer in bullion and corresponding loss to the government.

In reply to this Professor Fisher urges: (1) that prices will in all probability continue to rise for a number of years;⁴ (2) that the weight of the coin dollar might be reduced from 25.8 grains to 20 grains or 15 grains, either at once or when the contingency appears;⁵ or (3) that if “the index number actually shrinks below par by a substantial amount (say 10 per cent) then all gold coin is to be withdrawn from circulation and gold certificates substituted (or new gold coins of lighter weight).”⁶

The application of the third of these suggestions may be considered first. There would be many obstacles encountered in any attempt to effect the exchange of certificates for coin. Even if the certificates thus issued were redeemable in dollars of the same weight as the ones surrendered it is hard to understand how holders of the coin could be compelled or persuaded to surrender it. Presumably they now hold the coin instead of certificates because they prefer

³ *Quarterly Journal of Economics*, February, 1913, p. 13.

⁴ *AMERICAN ECONOMIC REVIEW*, September, 1912; and *North American Review*, December, 1912.

⁵ *Memorandum on A More Stable Gold Standard*, p. 15. This suggestion does not seem to appear in Professor Fisher's later discussions of the subject.

⁶ *Quarterly Journal of Economics*, February, 1913, p. 14. Also in *The New York Times*, December 22, 1912.

it. Habit strengthened by prejudice sets the custom of each community and so determines the nature of the cash holdings of the banks, as well as the medium of exchange among the people. Or perhaps the needs of the banks in connection with foreign gold shipments make convenient the holding of a considerable amount of gold coin and bullion. A certain quantity of the metal itself is needed and the passage of such a law as the one proposed would in no way change this need.

But if the exchange of certificates for coin could be effected nothing would be gained, so long as the certificates were made redeemable in dollars of the same weight as the ones surrendered. If a reserve of 100 per cent were kept behind them there would be no change in the situation. The same amount of gold represented by certificates would be outstanding and prices would not be affected. If a reserve of less than 100 per cent were kept, these pieces of paper would no longer be certificates of deposit (except perhaps in form) but would become government notes, protected by a reserve as are the greenbacks. Probably Professor Fisher would not advocate such an issue of government promises to pay, an idea which elsewhere he seems careful to avoid by insisting that any "seigniorage," accumulated by the operation of the plan when prices are rising, is not to be disposed of but held as a trust fund. At least, it is important to understand clearly just what his proposal signifies.

The other alternative is a certificate redeemable in a dollar of a reduced weight. Such a proposal, even though unobjectionable on any other grounds, would greatly increase the difficulty of calling in the certificates. Popular sentiment against "debasing the standard" would be aroused and the coin would be withheld. Moreover, the gold certificates now outstanding amount to over a billion dollars and they could not, without violation of the promises on them, be redeemed in anything but a 25.8 grain dollar. Unless they could be called in, we would have outstanding two kinds of certificates redeemable in different amounts of gold and hence of different value. The annoyance of this in daily business transactions would be difficult to estimate.

The second of the suggestions is that the weight of the coin dollar be reduced either at once or when the contingency arises. Even though no real ground for objection existed, a proposal to reduce the weight of our dollar under any conditions would encounter a storm of protest. Belief in the importance of a dollar

of constant weight and fineness is too deep-rooted to be ignored. There would, however, be real reason for concern. Long-term contracts as expressed in bonds and contracts of lease would be affected in various ways. Some of these are promises to pay a certain number of "dollars," not specifying gold; others promise "gold dollars"; and still others carefully specify "gold dollars of the present standard of weight and fineness" or a definite number of grains or ounces of gold of a certain fineness. In other words, many such contracts are carefully worded to guard against changes in our standard, while others are not. A reduction in the weight of the dollar would result in an immediate and disastrous readjustment in the relative values of these securities.

Assume two bonds each for one thousand dollars due on the same date. The first contains no statement that payments are to be with gold dollars, or else does not specify gold dollars of "the present standard of weight and fineness." The second carefully promises payment in "gold dollars of the present standard of weight and fineness" or perhaps in a given number of grains or ounces of gold of a certain fineness. Prices fall 10 per cent and a reduction in the weight of the coined dollar is put into effect. The first bond being redeemable in the new light-weight dollar would at once become of less value than the second. When one stops to consider the immense number and the great variety of promissory notes outstanding, the seriousness of such a change becomes apparent.

Even if the first of the bonds just mentioned were as carefully worded as the second, its value would be impaired if it were secured by collateral in the form of other promises to pay which were not stated with similar care. Even the possibility of a reduction in the weight of the dollar would introduce into the value of the bonds a speculative element that would vary with the distance of the maturity date. Thus, differences in the wording of the promise, in the date of maturity, and in the nature of the security, would all contribute to an extremely complex and often inequitable readjustment of values if the weight of the dollar were changed or even provided for as a possibility.

If the value (in gold) of all these promises to pay were changed to the same extent, little or no harm would result. But if the value of one should remain the same while that of another was changed, there would be serious injustice. The difficulty lies in the fact that the effect would not be the same on all securities.

If this problem were met by the stipulation that the provisions of the new plan were to apply only to future contracts, great confusion still would result. Large numbers of outstanding leases run for 99 years and some of them for 999 years. Bond issues run from relatively short periods to very long ones.⁷ Until these matured or were retired the values of many of them would be seriously affected, and a prospective purchaser of a security would need in each case to inform himself as to the terms of payment. New issues would be payable in the light-weight dollar, while for perhaps several hundred years some of the older issues payable in the heavier dollar would be outstanding.

None of these difficulties will exist if prices continue to rise; and that they will rise is the firm conviction of many students whose opinions carry great weight. Professor Fisher has very fully and clearly stated the reasons for his views on the point.⁸ This paper is not the place for a reply, even if the writer were capable of presenting it. Yet we may observe (1) that the predictions are based on an acceptance of the quantity theory of money and (2) that authorities are by no means in agreement as to the future of price movements.

Authorities in general, whether quantity theorists or not, are by no means in agreement as to the probable future of the production of gold as compared with the growth of trade. Thus Hon. George E. Roberts, Director of the Mint, has recently stated:

It is an interesting question whether the gold supplies of the next 10 or 20 years will be sufficient to allow of further additions to banking reserves, corresponding to those of the past and to the natural expansion of trade and industry. . . . It cannot be safely predicted on the strength of present conditions in the principal gold fields of the world, that the production of gold will materially increase in the next 10 years.⁹

Sir Felix Schuster, governor of the Union of London & Smiths Bank, Ltd., recently said:

The demands for gold may be expected to show continuous expansion, which the increased production of gold . . . may be expected to be sufficient, but not more than sufficient to meet.¹⁰

Sir Edward Holden, chairman of the London City and Midland Bank, Ltd., at about the same time expressed similar views.¹¹

⁷ The West Shore Railroad First 4's mature on January 1, 2361.

⁸ AMERICAN ECONOMIC REVIEW, September, 1912; and *North American Review*, December, 1912.

⁹ Annual Report of the Secretary of the Treasury, 1912, p. 308.

¹⁰ New York Journal of Commerce, February 2, 1913.

¹¹ Ibid.

There is no occasion here to settle the controversy. It is sufficient to emphasize the fact that there is a pronounced difference of opinion as to the immediate future. Prices may continue to rise for some years longer or may fall.

But even if the general movement for years to come is upward there are minor price movements to reckon with. No matter how explained there comes every few years a decline. These reactions vary widely but at times result in a fall of even more than the 10 per cent suggested by Professor Fisher. This is shown by the accompanying table which gives three different index numbers monthly for the years 1907 and 1908 with the Sauerbeck number also stated quarterly.

TABLE 1.—*Index numbers.*

Months	1907			1908		
	Brad-street	London Economist	Sauerbeck	Brad-street	London Economist	Sauerbeck
January	\$8.91	2499	80.0	\$8.29	2310	76.0
February	8.99	2494	80.7	8.12	2309	74.5
March	9.12	2521	80.0	7.98	2266	74.1
April	8.96	2516	80.7	8.06	2263	73.8
May	8.93	2549	82.4	7.96	2195	73.6
June	8.99	2601	82.0	7.72	2188	72.9
July	9.04	2594	81.1	7.82	2190	73.1
August	8.93	2571	79.4	7.93	2190	72.2
September	8.82	2519	79.1	7.90	2168	72.5
October	8.85	2457	78.8	8.01	2200	72.2
November	8.74	2414	76.7	8.06	2194	72.2
December	8.52	2360	76.2	8.21	2198	72.8

The Bradstreet number reached a high point of \$9.04 in July, 1907, falling to \$7.72 in June, 1908, a drop of over 14 per cent. The Economist number fell from 2601 in June, 1907, to 2168 in September, 1908, over 16 per cent. The Sauerbeck number fell from 82.4 in May, 1907, to 72.2 in August, 1908, over 12 per cent.¹² To avoid the necessity of reducing the weight of the dollar (if the plan is to be adapted to falling prices), it would be necessary to consider some preceding date when prices were low as a starting point or to inaugurate the plan only when we are at a level that could be generally recognized as a low one.

Suppose that the plan were adopted at once (May, 1913), but

¹² These percentages are all calculated by viewing the amount of fall as a percentage of the high point taken as a base. Any other method of calculation would likewise give a decline of 10 per cent or more in each case.

that we consider the low level of 1908 as a starting point. Examining the Bradstreet index number we find the low level of \$7.72 in June, 1908. At present the Bradstreet number is \$9.13, a rise of about 18 per cent. Immediately it would be necessary to begin demanding the deposit of over 30 grains of gold at the mint for each coined dollar. Every holder of uncoined gold would suffer a sudden and serious depreciation in the value of his product. There would be a severe shock also in many other directions as the result of requiring so much "seigniorage" at the outset. Since there would have been no opportunity for an accumulation of "seigniorage" by the mint, any unusually heavy demand for redemption of gold with bullion at the "redemption-bullion" (a price which would be only slightly less than the 30 grains just mentioned) might cause the government serious embarrassment.

If, instead, we adopt our present level of prices as a starting point we face the possibility of a fall in these prices at any time. There has already been a drop from \$9.18 in December, 1912, to \$9.13 in May, 1913 (Bradstreet index number). If Professor Fisher is correct in his conclusion that we are approaching a crisis,¹³ it must be recognized that even though the present decline does not continue a crisis will probably be accompanied by a fall similar to those of the past. A "compensated dollar" could not check such a fall without the disastrous results described above.

No matter how the device is modified it cannot safely be applied to prevent falling prices. Since prices may not continue to rise and since in any case we may reasonably expect periodical reactions in the price level, the value of the plan as a solution for immediate problems is open to question. It certainly is debatable whether a remedy that is, at best, only a half-remedy should be adopted. It is even more doubtful when so many other objections exist.

A second reason for criticising a compensated dollar is its effect upon the exchanges and hence upon our foreign trade both in commodities and in securities. This, of course, assumes that the plan would not be adopted internationally, the reasons for such a view being very clearly presented by Professor Taussig in the article referred to above. If adoption by a considerable number of leading countries could be secured this difficulty could not arise.

That the exchanges would be affected Professor Fisher admits.¹⁴

¹³ AMERICAN ECONOMIC REVIEW, June, 1913, p. 345.

¹⁴ His ready admission of the serious effect on foreign trade is surprising. In reply to the question, "Would not the adoption of the plan by the United

If prices rise and "mint-bullion" is increased, the miner would at first send his gold to England and then draw exchange against it. The resulting increase in the supply of exchange would force down the price to a level at which further exportations of gold would be unprofitable. This point having been reached we would for the time being have a new "par of exchange" at say \$4.82. If prices should then fall, the reverse movement would occur and "par of exchange" would rise to \$4.8665 or to some other level. Whether the fluctuations in exchange would be immediate or would be at all proportionate to the changes in the index number and in the corresponding changes in "mint-bullion" may be open to question. The value of the plan is dependent on the correctness of the belief that commodity prices would respond readily to the changes in "mint-bullion." Such prompt changes in prices would bring correspondingly prompt changes in foreign exchange. As we are proceeding on the assumption that the plan is theoretically sound and would produce the results expected of it by its author, let us examine the effect on our foreign trade.

That there would be fluctuations is clear, but in these fluctuations there is danger, the seriousness of which does not seem to have been fully realized. In discussing the point one must keep in mind that it is proposed to have monthly or quarterly adjustments. If exchange quotations changed promptly after each announcement there would be a sharp fall or a sharp rise that would introduce a speculative element into all transactions involving the use of foreign exchange. If the response were more gradual, there would still be numerous wide variations.

When it is remembered that a large amount of our foreign trade involves or should involve the extension of credit for periods as long as three to six months or occasionally a year, one begins to realize the seriousness of a proposal that makes wide fluctuations possible. At present, sight sterling ordinarily fluctuates between approximately \$4.84 and \$4.89, and time drafts between limits correspondingly close together. Much less than this amount of difference is sufficient to make arbitraging profitable and to justify bankers who have obligations abroad maturing in the future in buying in advance exchange for delivery to them at the time these foreign

States alone play havoc with our foreign trade?" he answers "Yes, most certainly. Foreign exchange would become uncertain and variable. While the plan could be worked if adopted by one nation without the concurrence of others, its benefits would be best secured through its adoption by a number of nations." *The New York Times*, December 22, 1912.

obligations must be met. On the other hand, the American exporter who fears a fall in the exchange will in a similar manner protect himself by "selling short" on exchange in order to prevent a loss. If the limits between which exchange may fluctuate are widened, the uncertainty is correspondingly increased and international transactions both financial and commercial become precarious.

Let us notice first the extent to which these fluctuations would take place. Professor Fisher has made careful calculations of the price movements that would have occurred had his proposal been adopted in 1896 or in December, 1903, with the prices of each of these dates as a base.¹⁵ Table 2 repeats the index numbers as he gives them, showing the price fluctuations that would have occurred had his plan been put into effect on either of the dates indicated. In parallel columns are given the various exchange levels that correspond to the fluctuations in the index numbers. Thus in column I the index number of 100 for 1896 has \$4.8665 as the corresponding par of exchange. By January, 1904, prices having risen by 1½ per cent, there would have been a drop of 1½ per cent in "par of exchange" to \$4.7936. The drop in prices by July, 1904, to 98.4 would have given a rise in exchange par to 1.6 per cent above \$4.8665 or \$4.9443. This first column gives the results with a 1 per cent brassage with quarterly adjustments, the prices of 1896 being taken as the base. Column II gives similar figures, the base being the same and the adjustments quarterly but with a 3 per cent brassage. Column III uses the prices of December, 1903, as a base with a 1½ per cent brassage and monthly adjustments.

Some of the fluctuations are worth noticing. Those of column III are the least violent, but from March to May in 1904 the rise is from \$4.85 to \$4.90; and from October to December of the same year there is a fall from \$4.93 to \$4.86. From July, 1907, to January, 1908, the rise is from \$4.85 to \$5.01; and from July, 1908, to January, 1909, the fall is from \$5.02 to \$4.85. In columns I and II the fluctuations are even more pronounced.

In some instances these extreme fluctuations might be very slightly offset by the ordinary influences that affect the price of exchange but at other times these same influences might act in such a way as to increase the variations. It scarcely seems necessary to emphasize the injury to trade that would result from

¹⁵ *Quarterly Journal of Economics*, February, 1913, p. 22.

TABLE 2.—*The index number and "par of exchange."*

	I Brassage 1 per cent Adjustments quarterly		II Brassage 3 per cent Adjustments quarterly		III Brassage 1½ per cent Adjustments monthly	
	The index number	Par of exchange	The index number	Par of exchange	The index number	Par of exchange
	100.0	\$4.8665	100.0	\$4.8665
1896						
1903 December					100.0	\$4.8665
1904 January . .	101.5	4.7936	100.5	4.8422	99.8	4.8762
February . .					100.9	4.8228
March . .					100.2	4.8568
April . .	101.2	4.8082	100.7	4.8325	99.5	4.8908
May . .					99.3	4.9005
June . .					99.5	4.8908
July . .	98.4	4.9448	98.2	4.9540	98.8	4.9248
August . .					98.8	4.9248
September . .					98.8	4.9248
October . .	99.2	4.9054	99.0	4.9151	98.6	4.9846
November . .					99.4	4.8956
December . .					100.1	4.8617
1905 January . .	102.0	4.7692	102.0	4.7692	100.4	4.8471
April . .	101.5	4.7936	100.5	4.8422	99.7	4.8810
July . .	100.2	4.8568	99.7	4.8810	100.2	4.8568
October . .	102.9	4.7254	102.9	4.7254	100.8	4.8276
1906 January . .	104.6	4.6427	102.7	4.7352	100.8	4.8276
April . .	103.8	4.6820	100.2	4.8568	99.9	4.8713
July . .	103.7	4.6865	100.9	4.8228	100.4	4.8471
October . .	103.8	4.6816	101.1	4.8180	100.7	4.8325
1907 January . .	106.4	4.5551	103.6	4.6914	102.0	4.7692
July . .	106.2	4.5648	100.9	4.8228	100.2	4.8568
1908 January . .	100.7	4.8325	96.0	5.0611	96.9	5.0173
July . .	97.7	4.9784	94.7	5.1244	96.7	5.0270
1909 January . .	101.6	4.7887	98.6	4.9346	100.3	4.8520
1910 January . .	104.5	4.6476	102.9	4.7254	100.4	4.8471
1911 January . .	98.5	4.9394	98.5	4.9394	98.9	4.9200

such a state of affairs, but perhaps a few illustrations should be given. In 1891 Sir David Barbour, in bringing forward the Indian budget for the ensuing year, took occasion to discuss the effects of the fluctuating rate of exchange on India. A few extracts from his remarks at that time are as follows:¹⁶

What India requires is not a high rate of exchange rather than a low rate, but some system under which fluctuations in exchange shall be neither great nor frequent, and shall oscillate round a fixed point. . . .

¹⁶ Sir David Barbour, *The Standard of Value*, pp. 196 ff.

The theory of a beneficial stimulus to trade owing to fluctuations in exchange between countries having different standards of value is an untenable and mischievous delusion. A sudden rise in exchange such as we had this year will unquestionably check business for a time and cause a depression of longer or shorter duration. . . . Almost anything would be better than to accept violent and continual fluctuations in exchange as our inevitable lot for all time.

The United States Commission on International Exchange, appointed in 1903, begin their report as follows:¹⁷

The gradual fall to a lower level of value and the serious fluctuations in the gold price of silver bullion for the past ten years have been slowly but unceasingly undermining the commerce of the important silver-using countries which do not have gold as a basis for their monetary systems. The fact that the importing merchants of such silver-using countries cannot reckon upon the cost in their own local currencies of the remittances in gold, which they must use in making settlements for purchases made in gold-standard countries, has been slowly but surely producing domestic commercial paralysis, checking foreign investments for the development of public and private enterprises, and hampering the importation of the products of the labor of the gold-standard countries. The more enlightened nations which suffer under such stress are alive to the importance of rescuing themselves from the disaster which is surely impending, but, by reason of individual burdens and general conditions, are not strong enough in all cases to place their monetary systems upon the full gold standard with the general use of a gold currency.

This entire report and the one submitted the next year by the same commission are filled with illustrations of the dangerous effect on commerce and business of a fluctuating exchange rate.

A concrete illustration of the loss that may be suffered is found in the following which is quoted verbatim from Margraff's *International Exchange*:¹⁸

In February last, a certain banker sold a draft on Mexico City payable in Mexican dollars at the rate of $37\frac{3}{4}$ cents per Mexican dollar, advising the draft on date of issue to his correspondent in Mexico, and requesting reimbursements of its equivalent by draft upon his New York bankers. The banker was cognizant of the fact that the value of the Mexican dollar was subject to sudden and violent fluctuations, and knowing this, endeavored to protect himself from a possible loss by charging his customer a price in excess of the current rate of exchange for the Mexican dollar, and in so doing believed himself amply protected.

In due course his Mexican correspondent acknowledged receipt of advice, relating to draft issued, and informed him that the draft would be promptly protected upon presentation, and reimbursed for, in the manner desired on the date of payment of same.

¹⁷ Report of October 1, 1903, p. 11 (Sen. Doc. No. 144, 58 Cong., 2 Sess.).

¹⁸ Second edition, p. 101.

Instead of the draft being presented for payment, within the usual time, it was held by the payee, who happened to be the purchaser, until April the fifteenth. During the intervening time, February to April, 1903, the price of silver steadily advanced so that the Mexican dollar sold by the banker and represented by his draft issued in February, at the rate of $37\frac{3}{4}$ cents, was quoted and converted in April by his correspondent in Mexico City at the rate of $38\frac{7}{8}$ cents resulting in a loss to the banker issuing the draft of $1\frac{1}{8}$ cents on each dollar less the accrued interest on the money paid for the draft during its circulation.

As international trade develops the necessity for more certainty will increase. The margin of profits is narrow and speculative features should be carefully excluded. Moreover, one of the most serious weaknesses in our foreign trade relations at the present time is the unwillingness of the American exporter to grant long credits to the foreign importer.¹⁹ Growth in trade is dependent on an encouragement of this policy but longer credits mean a longer period during which prices for exchange may widely vary.

The above quotations and illustrations all have reference to the fluctuations in exchange on silver-using countries, but the significant fact is that the immediate cause of the difficulties cited was in every case a fluctuating exchange rate. Variations in the gold price of silver may have been the underlying reason but the fluctuations were the source of harm. Any influence that would cause uncertainties in the rate of exchange between the United States and other countries would have similar bad effects. A compensated dollar by its very nature and by the admission of its sponsor would create just this sort of situation.

The movement for a gold-exchange standard in silver-using countries has been due to the facts just cited. Its adoption in many of them seems to have solved the problem and to have encouraged trade and investments. In some respects the compensated dollar may be similar to the gold-exchange standard, as Professor Fisher asserts, but as thus far outlined it lacks the one feature which is most important—the power to maintain stability in our exchanges. The only method by which such stability could be secured is by definitely announcing our adoption of the gold-exchange standard. Our government would then stand ready, as do those of other gold-exchange countries, to buy and sell exchange at all times, at such a price as to keep the rates stable, the drafts being sold against accounts in the center or centers against which they were drawn.

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¹⁹ A thorough study of this is to be found in *Foreign Credits*, published by the Bureau of Foreign and Domestic Commerce, Special Agents Series, No. 62.